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McMillin, John Milton

Relation of earnings to credit

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[1920]

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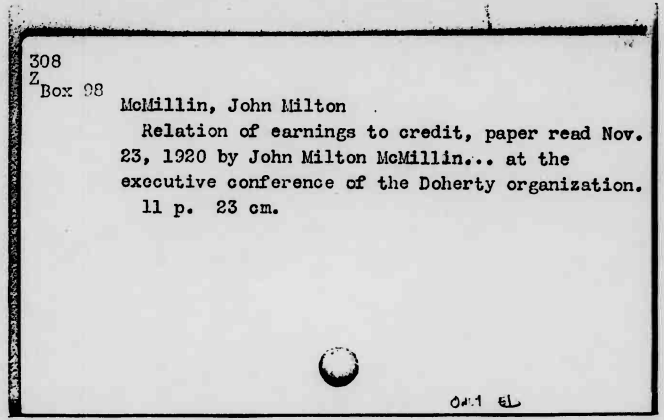
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McMillin, John Milton
Relation of earnings to credit, paper read Nov. 23, 1920 by John Milton McMillin... at the executive conference of the Doherty organization.
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RELATION OF EARNINGS TO CREDIT

PAPER READ NOVEMBER 23, 1920

BY

JOHN MILTON McMILLIN,
ASSISTANT MANAGER BOND DEPARTMENT

AT THE

EXECUTIVE CONFERENCE

OF

THE DOHERTY ORGANIZATION

The poor, suffering head of the public utility manager has become the target for all sorts of brickbats. Householders, power consumers, politicians, bondholders and stockholders, are all charging upon him from every direction, blaming him for whatever has gone wrong and crediting him with little that is good.

The private citizen who used to sit contentedly under the light of a flickering gas jet now has a fit if the electric service shows one single flicker in a month at a time. Of course it is the manager's fault if the pole line went down in a tempest, or if an armature burned out, or if the lightning may have shimmied into the switchboard. The manufacturer who so lately regarded the electric central station as the luckiest kind of solution for his power problems, now sends up a war-whoop if the voltage goes down under a peak load three times his usual demand. He also declares there is no reason at all for the price of the service, since the bill is figured according to a lot of superscientific, incomprehensible principles entirely foreign to any orthodox business practice.

Politicians and Chambers of Commerce, who so lately welcomed the new installation of a great power station as a milestone in the ambitious career of their promising city, now turn a scornful eye upon sworn statements of inadequate earnings. If the company is not making money, why, of course, that is the fault of bad management. It cannot possibly be due to the rates, which are certainly high enough.

Bankers and stockholders refuse the manager's drafts for more money, and write him long theses in regard to operating expenses. It is his fault, of course, if he bought coal in the spot market at double the price which he had some due to receive under contract that never arrived. It is his fault that a construction program overran the estimate by 100%. He should have anticipated that. If the business cannot be made to pay because of a franchise, then he never should have accepted the franchise in the first place. Of course if the property happens to be making money, then the credit for that achievement is due to the superior foresight of those who originally conceived the enterprise. The public utility manager had a controlling hand only in situations that are wrong. The din and hullabaloo of all these scoldings make up so much of his life that sometimes he looks with envy upon a man locked up in solitary confinement. At least that particular criminal gets a little peace and quiet.

The manager has not been without abundant advice as to how he might improve his situation. All of these protests were accompanied by recommendations as to what he should do. He has sat through hundreds of sermons covering all chapters of the business from Genesis to Revelations, but feels that none of these people really understand his situation and that none of their recommendations will work. He has already tried all the schemes they have suggested, and many others that they never heard of. He has priced and extended all this free advice and found that the total valuation foots up to his exact cost now.

Here today he is obliged to sit and listen with reluctant courtesy while a humble security salesman, representing the investor, will endeavor to make a few suggestions regarding the relation of earnings

to public utility credit, and of course your credit rating depends entirely upon what the investor thinks. Like all the others, the present evangelist will try to prove that his is the one good and true story of salvation.

Sometimes in those rare moments in the life of a public utility manager when he is afforded a fragment of leisure for reflection, he has almost come to the point of regretting his vocation, and seeking some business where earnings and profits actually are in the control of the management instead of resting in the lap of the gods.

You should remember that the investor is a man of such diversified activities that he has seen trouble before. In his list of security holdings there is rarely a time when some one group or another is not giving him at least a little anxiety. Accordingly you ought to permit him to give you this one word of cheer: your troubles are not exclusive, probably not all unsurmountable, and you may have created some of them yourself.

If in 1917 you had been a railway executive, you would have thought that the prospects for that business were almost hopelessly black. You would have looked out upon a more comfortable situation in the public utility world. You might have played a very good joke on yourself if you had shifted from one enterprise to the other at that time.

You do not have any monopoly of trouble. There is a little of that in any kind of business. Indeed, your friend, the investor, has learned never to give up hope no matter how great the present complications may appear, just so long as the enterprise under consideration is engaged in the business of rendering a useful service or producing a useful product, and just so long as the product or service has at least an even fighting chance in competition with any other substitute. Some one may build a bridge and put a ferry boat out of business, but no one even conceived a bridge which can do that to the enterprise in which you are engaged.

The investor would earnestly suggest that you harden your heart in respect to the hoodoo of "special conditions". Public service customers have developed "special conditions" as a fine art. Academically, all consumers agree that any business must make a decent profit if it is going to live. They will admit without argument that this is true even in the case of a public utility, with the possible exception of the one from which they obtain service. The public has succeeded much too well in selling the idea, to itself and to the corporations, that public convenience in regard to price and quality of service is the primary matter, and that the welfare of the business should receive secondary consideration, if indeed it be entitled to any at all.

The result is, that when you sit down to figure the amount by which your rates should be increased, you can scarcely avoid recalling to mind what the effect will be upon your customers. You visualize them coming before you one after another like so many phantom spirits. One says his electric bill last month was high beyond all reason. He intends to put in a plant of his own regardless of cost, and he refuses to listen to reason. Another serves notice upon you that if you ever raise the rates any further, he will go to the public service

commission and show you up. The next phantom says he heard of several big power users in that part of the country who were endeavoring to work out a plan for the construction of a great power plant of their own. Still another asks you how on earth you expect him to continue in business in competition with some other spirit, some other place, who has a power rate not so high as yours. And the phantom image of a certain politician tells you in the strictest confidence, that there is no way on earth to prevent a public investigation of your whole state of affairs, if you ever make another rate increase, before effecting great improvements in your service, and put an end to interruptions. These and hundreds of others pass before your mind in constant procession, when you try to work out a new rate schedule. They flit by in a never ending haze between your eyes and the paper upon which you are endeavoring to make some figures. They befog your vision. You realize dimly that the rates ought to be advanced all right. They could be at any other property, but you very likely have a very cold, sick and clammy feeling that nothing can possibly be done just now in your situation, owing to special conditions.

Now your friend the investor insists that these so-called special conditions are not special at all; not in your property, not in any other public utility, and not anywhere else. The investor would like to inquire of you what other attitude you expect in your customers, than to make every effort to keep the rates down. Who, beside the producers, think the price of gasoline is not too high, or hats, or shoes, or theatre tickets, or fines for speeding, or anything else? Is it not a universal practice for any buyer to pay the least which will be accepted by the seller? Do you expect your customers to come to you, one at a time, and tell you how sorry they are that you lack the nerve to charge them what they ought to pay? Do you expect them to say that they do not see how you can live under your present rates? If so, you belong in heaven, not in the public utility business.

If you will stay home some day and listen to what your wife says to the butcher, the iceman and the grocer's boy, you will hear so much familiar old stuff that you will think you are down at the office. And on careful inquiry, you will find she used to make practically the same protest, when eggs were thirty-two cents a dozen, that she does at $1.08. Then, as now, the price was unreasonably high, and the eggs exceedingly bad.

Investors are entirely cold with reference to any kind of special conditions. They are investing their capital for their own benefit and they expect you to keep that point in mind, in acting as their agent. Among them are always great numbers who are dependent upon income from securities bought with the savings of years of toil. There may be some who cannot pay the rent on a home, when their investments prove disappointing. You have a sacred trust to perform in the administration of great sums of capital supplied by men and women in all walks of life. They rely upon you to guard their interests with resolute courage, and it is small comfort to them if you are bewitched by a lot of fairy tales.

What if some customer says that if your rates are advanced, he will have to go out of business. So be it. If some one has to go out of

business, whom do you prefer it should be, yourself or him? Last winter, when the same man wanted a suit for $50.00, did his tailor not say that his choice lay between paying $100.00 or having no suit? Did he not convey the impression that sooner than sell the man a suit for $50.00 which cost him $75.00, he would cheerfully see the man naked? Suppose the tailor had acceded to the plea that the man simply could not pay more, but must have a suit, and supposing that as a perfectly natural result he had since gone into bankruptcy, what would everyone be saying of him now? They would say he was a very good fellow, but an exceedingly poor business man.

What have you to fear, either, from the man who proposes to hale you before the public service commission? Is his case any stronger than yours? Can the man who threatened to put in his own plant make the power any more cheaply than you can? Can the threatened explosion by the politicians show you up in any bad light, even if they should find that you are making a success of the business? Can you imagine your consumers hold you or your company in any higher regard, whenever they are able to jolly you out of what the property is entitled to earn?

Your friend the investor thinks that there is no one element of the public utility business which has been nearly so much over-capitalized, as the idea of the public rights and privileges. Whatever the story of special conditions, particular needs, and threatened investigations, your customers may tell you, you must keep both your charity and your caution within reasonable bounds. Let the other man solve his problems; you solve yours. Never forget that your credit depends upon earnings statements, balance sheets, interest and dividends, not upon explanations. Where will you get more money for the continuing growth of the business, unless you can show that the dollars already invested have earned good wages? Forget for a moment the cash balance at New York, which has so often been used as a pillow for financially bewildered heads, and ask where things would be coming out at your plant, if advances of funds depended solely upon your earnings statement and your record to date as a prophet. The investor would like to be sure of registering the thought with you that these considerations apply not only to the man sitting beside you, but, with equal emphasis, to your administration of the property which you individually have in your care.

Investors are guided by very simple and practical business principles. They purchase the various class of your securities with just one fundamental thought in mind, namely, to find a good job for their dollars. They classify themselves into bond buyers, stock buyers, and so on, according to their individual views in matters of detail, but their one idea is to find profitable and satisfactory employment for their savings and accumulations. Now let us consider how they got into business with you and what the result has been to them.

The bond buyer generally classifies himself as the most conservative of them all. He does not wish to take any of the risks of your business. He desires merely to lend you his capital at a certain rate of interest and he expects to get his money back at a certain definite date. Since he is only to receive a fixed rate of interest on his money, and cannot participate in any unusual success your company may enjoy, he insists

upon having his loan made entirely safe by the pledge of your physical property under a mortgage. He will only lend a sum or participate in a total loan, which is less than the value of the physical plant. He has no thought of ever becoming the owner of the property himself. He deliberately shuns any situation where there is the remotest visible likelihood of his having to foreclose and take over the property. His general theory in respect to the mortgage is to make its terms of such a character that you will find it more advantageous to pay off his obligations when due, than to let him have the plant.

The bond buyer wishes a factor of safety not only in the amount of physical property but also in the earnings statement. Quite generally he will not invest in a situation where the earnings available for the payment of interest charges on his obligations amount to less than double the sum actually required. The biggest chance he is willing to take is that your net earnings may be cut in half. In making the calculation he adds the interest requirements of any prior liens to his own, and notes the ratio of net earnings. He does not subtract prior interest charges and compare the balance of net earnings to his own interest requirements. He compares the net earnings to the whole funded debt, excluding only such issues as may be junior to his own.

Furthermore, the bond buyer looks backward. Usually he is not in the least degree interested in estimated earnings of the future. In this matter he takes the position that if an estimate is achieved, then the best that can happen to him is that he will be paid. In other words, he has everything to lose and nothing to gain. Accordingly, he wants to see what you have done before. When he is being shown whether or not the interest on a bond is being doubly earned, he insists upon a statement of at least twelve months' results. And he will not give you credit for that either, if there has been any marked decline during the latter portion of the period.

You may say that a bond buyer is a pessimist, that he only looks into the past, that he lacks imagination. In fact you may say what you please, but these are his terms and must be complied with if you expect to do business with him. On the basis of your present results can you face your bondholders and ask for more money? If not it will be useless to protest that the conditions are no fault of yours. They will only say the troubles are not theirs either, and tell you to stay out of the game until you get some cards.

If you have a plan of expansion requiring a large amount of capital, you may only count upon support from bond buyers if you can show them that your present established earnings amount to about double the interest on your proposed funded debt. You will argue in vain that the new plant will make important savings in operating expenses, that it will produce a great amount of new business, and that it is certain to be a success. The bond buyer will allow you small credit for what you estimate will happen, but he will put a microscope on your past. If your earnings now on record will not show double the interest requirements on the total debt (allowing at present for about an 8% rate on the new issue) you would do very well to eliminate the bond buyer from your estimate, unless you can afford to take a speculative price for the bonds.

The preferred stock buyer has a somewhat different investment

philosophy. He is the investor who will deliberately take a slightly larger risk with respect to his principal in order to receive an equitably larger return on his capital. Part of the increased income he receives takes the form of reduced taxes, for income on dividends is not subject to the normal Federal Income Tax, and in certain states there are important local tax conditions to take into account. He is willing to take a position junior to the mortgage bonds of the company and junior also to its floating indebtedness, but he desires to have a first call on dividends ahead of the common stockholders. Since he has a first call, he is willing usually to accept a limited rate of income; and since he has to take a position junior to the mortgage bonds, he expects a higher rate of return on his money than the bondholders receive. Unlike the bondholder, he is not always particular as to the exact amount of physical property which his investment may represent. He is usually willing that only part of it be in plant and the remainder may consist of current assets. That is to say, he is willing to become a stockholder, with a certain set of preferences applying to his particular security. Usually, he does not demand nor expect that a public utility corporation shall ever repay his principal except in the remote event of the liquidation of the business.

Sifting down all these conditions, you will readily see that the biggest single factor in which he is interested, is the amount of earnings which are available for the payment of his dividends, for nothing else really matters to him. For instance, it is not going to help him very much whether there is physical property or current assets which combined are equal to either more or less than the par value of his stock. None of these items will help him much unless the enterprise is earning a sufficient amount to pay his dividends. Accordingly, he generally requires even a larger factor of safety than a bondholder will demand. A preferred stockholder wants to see an earnings statement, which, after the payment of interest on both funded and floating indebtedness and any other charges, will leave a balance available for the payment of preferred dividends, three or four times the required amount. He will not even be satisfied with that much of a factor of safety where an industrial business is involved, but he will generally think this amount is sufficient where the enterprise is of some permanent character such as that of a public utility.

If you expect help from this capitalist you will see that, just as in the case of the appeal to bond buyers, the very foundation of your claim to consideration will consist in your rear earnings statement. The preferred stock buyer will be glad to see that you expect to increase the earnings, but unless they are adequate now, he will only be willing to pay you a speculative price for your stock. What other rational point of view can you expect him to take, in view of his accepting a definite limit upon his dividends regardless of how successful the business may be?

Of course there is an exception in the case of local investors. Those who live in your community, and who have noted how well you have managed your business in the past, will purchase preferred stock in your company although the earnings statement may be less than the general market will demand. Nearly everyone likes to have some of his investments close at home, and we have made a great deal of

progress in selling securities to consumers, as you know. This is entirely logical for both the investor and the company, for, of course, a public utility with a good many local stockholders has just so many dependable friends to help mould public opinion. But if your project runs into millions of dollars you must give great heed to the orthodox requirements in regard to earnings, for you will have to carry your sales efforts into wider markets.

You also have to reckon with the investment philosophy of the common stock buyer. The common stock of your operating company is not offered for sale to the public, of course, being entirely owned by Cities Service Company, but you may say that the latter corporation merely takes your place in marketing common stock to raise part of the capital for the business. Investors who confine their capital to bonds, generally refer to stock buyers as pure speculators, but this is not true. They are investors the same as all other security buyers and their purpose is just the same, namely, to find the best employment for their money that they can. They are willing to face a larger element of risk than the others, but you will usually find that they diversify their purchases, and that they have a very shrewd regard for the preservation of their principal.

Their investment theory is that even though they may make a mistake in some one item, they are more than likely to regain the loss in something else and thus keep their principal intact. Over a period of years they generally succeed about as well as any other class of investors in preserving their capital and making it earn good wages. Consciously, or not, the careful investor in common stock makes a mental division of the expected benefits about as follows: First, the investment must probably afford a fair income; and second, it must afford possible compensation for any risk involved. He waives all demand for the security of his principal through the execution of a mortgage such as the bondholder demands. He also waives the preference demanded by preferred stockholders. He expects that the enterprise will earn very substantially more than the fixed rate of interest and dividends which these prior security holders are to receive. He is the optimist among security investors. He is the man who looks forward, not backward. He will listen with interest to your estimate of future earnings. He is the man with faith. Never get the idea that common stock investors are mere enthusiasts. They are just as careful as other buyers of securities. They are just as scientific in their theories, and some say that on the average they are possibly the most successful of all. Of course there are people with money to whom a clever stock salesman can sell a gold brick. But the wide general market from which important and dependable amounts of capital are raised by the sale of common stock is made up of men who think.

Now ponder the question. How much does your present earnings statement contribute to the income and the expectations of these various friends of yours? Courteously but firmly, forget your consumers and your special conditions, and examine your record as the custodian of millions of dollars of other men's money. Some of it is your own, as a matter of fact, for you are a security holder in Cities Service Company yourself. Will you continue to permit the clamorous public to sell you their proposition, or will you sell them yours?

In some situations your rates are less than you can readily justify before public service commissions having final authority over that question. Do you think, if the condition were opposite, that your many good friends among public service consumers would hesitate very long before initiating a revision of your rate schedules downward? Would they all be good fellows and let you go on making extortionate profits? Did they ever do anything of the kind in the past? It is not their next move in a case like this: it is yours.

There are limits beyond which you may not go in applying some customary business practices to the conduct of a public utility. You are restrained not only by law, but also by our whole policy, from being so independent as the tailor was about the suit. The investor knows that perfectly well. He did not buy your securities with any understanding that you could defy or rob the public for his account. But he deliberately sacrificed any expectation of great commercial earnings in a definite exchange for something else, namely, the assurance of at least a moderate rate of return. Wherever he has lost out in the trade, he holds the management strictly responsible to exhaust every proper means of redress. He is almost helpless in respect of such dollars as are already buried in a losing situation, but there is no means, legal or otherwise, whereby you can compel him to invest further sums. His additional dollars are free to seek better employment, and they will. He is being solicited and courted by others who want capital in every industry, in every country, and even the seven seas. You must make a bid for these new dollars in competition with all the rest of the world. One of the most effective bids is a satisfactory and stable earnings statement.

The central money pot of Cities Service Company would be under very bad administration indeed if those who control it were governed by any different ideas from those which guide any other investors. Those officers and executives take a view representing the composite of all investors, for they are interested in all classes of securities, bonds and notes, and preferred and common stock of all of the subsidiaries. They look at the total investment in your property and compare the net earnings to see what your average dollar in the business is earning. If the answer is 5%, why should they look with favor upon further drafts for cash from you, if they can make such better investments in other properties, and especially when they can place the funds to better advantage even by the purchase of Cities Service stocks and bonds in the open market? You are very earnestly urged to get around to the point of view of the dollar in your business, and stay there. Concede to the public no more than their reasonable right to service at a reasonable cost. But never become hypnotized into the idea, that the business can grow, or even live, if the investor gets secondary instead of primary consideration in your mind.

Is it not a fair statement that every one of your troubles would disappear if your earnings were fair and reasonable? Disregarding the riddles of day-to-day routine, is it not true that the only problem which gives you any real concern is that of stretching a thin cash balance way beyond its elastic limit? It is simply the state of your credit that is the bane of your life. You would no longer be the target of criticism from bankers and investors, if your good old-fashioned earnings state-

ments were restored, and the brickbats of consumers would bounce harmlessly off your now suffering head if you had plenty of money in the bank. You can bring back the happy days of 1916, when your call was answered every time for almost unlimited millions, only after you bring back reasonable earnings to the business. If you would again enjoy the thrills of the good old days, work for the good of the business and banish the idea you are employed by the public. Brush away the phantoms and hoodoos, and get back your former sane ideas of the purpose of a dollar in business, for while it is safe to prophesy credit enough for your peace of mind after you have restored your earnings, nevertheless, it is important to say that this blessing will come only after the improved results have been apparent for some months or a year, to prove that they are not a mere flash in the pan. Your credit will come back, not before you are entitled to it, but some little time after that. The exact date of restoration is in your own hands in most cases.

In conclusion, we should state that your humble servant does not pretend his department has any right to specify operating requirements or to find fault with your results, except as representing the security holder. Neither is it to be assumed that all of these remarks apply equally to all properties. In many individual cases we are like the campaign speaker able to "point with pride to the record of the party." But we are not doing the best we can, unless we so far excel all others as to set the pace for the industry.

We should also remark that all of these observations which you have heard with such patience, are based upon the discussions we hold every day with that other portion of the public which we have to meet, namely, the bankers and investors upon whom we all depend for the capital requirements for the business.

They tell us that in our effort to get away from an earlier sin of years ago, when certain public service companies got into a lot of trouble as the result of a public-be-damned policy, we have let the pendulum swing clear to the opposite extreme and put the investor where the public was at that time.

We, here in New York, privately confess some share in your shame. Perhaps you got your bad habits from us. But the credit restrictions of bankers and investors have taught us a lesson, and we have endeavored to explain it to you:—Until public utilities show better earnings, we can't get them any more money!

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